

Your 501(c)(7) Private Club: Non-Member Income Generation to Be Separated into Lines of Business

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Does your 501(c)(7) private club hold non-member/outside events, and do these events generate a profit for the club? The IRS is now focusing closer on whether or not private clubs are properly calculating the profit and paying income tax.

501(c)(7) private clubs are allowed a limited amount of gross receipts from non-member activities generated from outside events such as golf tournaments, weddings and other social gatherings, room rentals, and reciprocals to name a few. If the non-member gross receipts are less than 15% of gross revenue (excluding initiation fees and capital contributions) there is no threat to the tax-exempt status of the private club.

The non-member gross receipts are reported to the IRS on Form 990-T and direct and overhead expenses are then allocated against the gross receipts, commonly using the gross to gross method. After this allocation, most 501(c)(7) private clubs report a tax loss on non-member activities and are left only paying income tax on their investment income.

On the Horizon: Income Silos

Proposed regulations were recently issued that, once finalized, will require 501(c)(7) private clubs to separate their non-member gross receipts into separate lines of business, or silos, and separately calculate the unrelated business taxable income (UBTI) on each silo. In addition, we anticipate that forthcoming regulations will cover strict guidelines that 501(c)(7) private clubs must follow, regarding how to properly allocate expenses against the income from these individual silos. The new silo rules will take effect starting in the tax year following the date the regulations are finalized, possibly 2021 for calendar year 501(c)(7) private clubs.

Get Ready

What does this mean for now? 501(c)(7) private clubs should start having discussions with their tax return preparer to determine how many silos they are deemed to have, and start tracking the costs related to these silos internally, which will make the tax filing more efficient and help the club plan for any tax that may be due. This will require additional record keeping on the various outside events the club holds throughout the year, in addition to general non-member usage of the club.

Specifics

The proposed regulations require 501(c)(7) private clubs to use the two-digit NAICS codes to separate non-member activities into separate silos. **Under the regulations, a loss from one silo cannot offset net income from another silo.** This will prevent 501(c)(7) private clubs from using losses from an activity that consistently generates losses to offset income from another activity.

After allocating expenses, each silo that generates a profit will be subject to the current corporate tax rate of 21%. If a silo generates a loss, that loss will be disallowed and unable to offset income from a profitable silo.

It is currently unknown whether profitable silos that consistently create profits will eventually be able to create a net operating loss (NOL) and use that loss to offset future profits, given the fact that the private club is engaging in an activity with a profit motive within that silo.

Some examples of separate silos 501(c)(7) private clubs may have are:

- Retail sales – non-member pro shop sales, ship stores or grocery sales (including beer, wine and other spirits)
- Property rental and leasing – non-member golf carts, beach chairs, cabanas, boat storage, non-member green fees
- Educational services – non-member golf lessons, sailing lessons, swimming lessons
- Entertainment and recreation– non-member day camps, boating, pool, fitness
- Accommodation and food service – non-member food and beverage, non-traditional food and beverage (take out), over-night rentals
- Other services – non-member personal care, parking lots/garages

This list is not all inclusive; however, it summarizes some of the most common silos your 501(c)(7) private club could have. As you can see, the club may end up with quite a few silos that have to be calculated separately.

Expense Allocation

The IRS requires 501(c)(7) private clubs to allocate expenses against non-member revenue on a reasonable basis. The proposed regulations clearly state that the IRS has determined the unadjusted gross to gross allocation method is not a reasonable method of allocating expenses. The IRS only wants to allow expenses that are directly related to the unrelated trade or business income – and these expenses would need to be tracked internally as the events happen. It may be simple to track direct expenses for a particular event or golf outing; however, day to day non-member usage of a 501(c)(7) private club must be treated a little differently.

The proposed regulations do not contain an approved method of allocating expenses; however, we anticipate that additional forthcoming regulations will require an allocation that is considered reasonable for each of the following types of expenses –

- Cost of goods sold – directly and primarily related to sales volume
- Fixed expenses – bear no relationship to sales volume
- Variable expenses – vary in some degree with sales volume
- Direct expenses – these costs directly relate to the non-member event

As you can see, each type of expense has a different correlation with sales, so one method will not work for all of them. Since cost of goods sold is directly related to the sales volume, the gross to gross method may be reasonable for allocating cost of goods sold, but the fixed and variable expenses will need to be allocated on a more intricate basis, such as a weighted number of days or even hours of non-member usage to be determined reasonable.

In summary, 501(c)(7) private clubs will need to start tracking direct expenses for these events on a real time basis and indirect expenses will be allocated using a more stringent method than in the past.

Coming to 501(c)(7) Private Clubs Soon

With the proposed regulations to be finalized shortly, and the increase in private club audits, it suggests that the IRS is focusing on obtaining more tax dollars from private clubs. This will result in the IRS examining these allocations closer than they have in the past to determine whether the 501(c)(7) private club is properly calculating UBTI and paying income tax on their non-member income.

We encourage you to take a look at the separate trades or businesses your 501(c)(7) private club may have now, so you can develop a plan for how to track expenses for these events accordingly.

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